

6 Europe 1992: Some Monetary Policy Issues

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Some dates do rather more than identify a point in time. They come to stand for a combination of historic developments that would otherwise defy simple description. The year, 1992, is just such a date: it symbolizes the determination of the European Community to weld itself into a single market, without internal barriers.

I want to say a few words today about what this means for central bankers, but I shall also range more widely as the 1992 project has been accompanied by an important debate on the possibility of economic and monetary union in Europe. This debate has already been fairly emotive, partly because it is colored by different views on the desirability of ultimate political union and partly because it raises issues concerning economic sovereignty, not least of which is whether we would have to give up our individual currencies and monetary policies. I shall try to avoid the more emotive aspects this afternoon. Rather, I want to use the opportunity of being here in Jackson Hole to consider what lessons the United States can offer Europe in the field of monetary arrangements.

Monetary policy in a European marketplace

Let me begin with some observations about the broad economic and financial background to the 1992 project, as it is essential that

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the institutions and instruments of monetary policy be designed to work with the grain of market realities and not against it.

As I am sure you are all aware, far-reaching changes are under way in the legal and regulatory framework of financial markets in Europe. By the end of 1992, financial institutions incorporated in one member state will be able to conduct business throughout the community. Capital movements, already largely free, will by then be entirely so. And the way should be open for free competition among financial institutions from both inside and outside the community. Despite some initial fears, it is, I hope, now clear that in the field of financial services, we will have almost the opposite of what has been caricatured as "Fortress Europe;" we will have "Market Place Europe." The scale of the changes will be so great that in an American context it would almost be as if nationwide interstate banking and the repeal of the Glass-Steagall Act were to be effected at the same time.

Meanwhile, goods markets will become even more integrated, and the remaining professional and administrative barriers to labor mobility will be eliminated. Goods, capital, and labor will be able to move as freely between the member states of the European Community as they can around the United States, although it will, of course; take time before that freedom is fully exploited.

Finally, there will be a significant development in the monetary field because, within a few years, the currencies of all member countries will participate in the Exchange Rate Mechanism of the European Monetary System.

As a result of all these developments, Europe will increasingly have to be seen as a single economic and financial area. This will have important implications for the autonomy with which individual European countries can conduct monetary policy and also, taken together with the globalization of markets and the integration of the world economy, for Europe's financial relations with the United States and Japan.

Goals of monetary policy

It is perhaps, therefore, more important than ever that we should be clear about our monetary policy objectives. The first and overriding goal must, of course, be the establishment and maintenance

of price stability. This is one of the greatest services that finance can render industry—or at any rate, instability is certainly the greatest disservice. History also suggests that the credibility of the authorities' commitment to price stability is a valuable resource that is easier to squander than to reacquire.

A second objective is exchange rate stability, which I put second because, to my mind, it has to be seen as following from a collective achievement of the first objective, and not as a goal that is independently attainable. Our immediate aim is to achieve and sustain exchange rate stability within Europe. On a global scale, international cooperation in the management of exchange rates between the three major economic groupings—Europe, North America, and Japan—has made significant advances in recent years, though we are still a long way short of anything that could be described as exchange rate stability. In pursuing this objective, the monetary policies of the three blocs must be consistent and, more particularly, aimed at internal price stability.

A third objective is to ensure the stability of financial systems. It has been recognized since at least the nineteenth century that the macroeconomic goals of price and exchange rate stability can be undermined if the financial system is unstable. For this reason, all central banks have developed ways of channelling liquidity to the banking system in periods of pressure and the arrangements for the prudential supervision of individual firms have been progressively strengthened.

I imagine most of us could agree, at least in broad terms, on these goals. The more difficult question is how we can achieve them in the changing economic and institutional circumstances of the 1990s.

The road to monetary union

We have all learned that economic interdependence limits the extent to which a single country, particularly a small or medium-sized country, can pursue an independent monetary policy. In Europe, this has led to increased coordination of monetary policy decisions and recently, to calls for moves to eventual economic and monetary union, which some see as an inevitable and logical conclusion of current trends. There is far less consensus, however, on the form such a union should take or on how rapidly it would be reasonable to pursue it.

As you probably know, the Delors **Committee** saw monetary union as ultimately comprising a single Europe-wide currency with a single monetary policymaking authority, which it called the European System of **Central Banks**. In addition, it envisaged that the arrangements for monetary policy would be supported by mechanisms for coordination in the fields of fiscal and regional policy.

The institutional structure would have some similarities with your own in the United States, in that the overall policy stance would be determined collectively—as it is by the **Federal Reserve Board** and the **Federal Open Market Committee**—while policy implementation (and, more particularly, market intervention) would remain in the hands of the national central banks. Consideration would, however, have to be given to how any new institutional structure would be made politically accountable—a question not addressed specifically in the Delors Report.

Wisely, in my opinion, the committee refrained from **expressing** views on the timetable within which monetary union should be approached and the new institutions should be established. Nor, significantly, did it make any claim that the model it described was the *only possible* model.

Limitations of the U.S. model

It is at this point that a comparison with the United States can be instructive. It is sometimes suggested that when internal barriers to goods and factor mobility have been removed, Europe will be "just like the United States"⁷ and could then benefit from monetary arrangements on the Federal Reserve model. Put in other terms, the advocates of rapid progress toward monetary union suggest that, once the 1992 program is fully implemented, Europe will be an "optimum currency area" needing a single currency and monetary authority. This neglects some important practical differences between Europe and the United States, however. In at least four respects, Europe is much farther away than the United States from being an optimum currency area.

In the first place, the degree of integration in goods markets is significantly lower in Europe. Despite the tremendous growth of trade in recent years, the four largest European countries export only about 10 percent of their GNP to partner countries in Europe. This is **signifi-**

cant, but still probably falls somewhat short of the comparable figure for regions of the United States.

Second, labor mobility is—and is likely to remain—much lower than in the United States. The European Community is probably even more culturally diverse than the United States, and while, in my view, this has many benefits, it does obviously limit labor mobility. In consequence, labor is less ready to move from place to place in response to developments requiring economic adjustments, and other adjustment mechanisms have to bear more of the burden.

A third difference lies in the lack of fiscal instruments to cushion the costs of adjustment to economic disturbances. In the United States, income **tax** and national social security provisions act to some extent as automatic mechanisms for transferring resources from richer to poorer regions, and from those with high to those with low employment. No such automatic fiscal mechanisms exist at the community level in Europe.

The fourth difference lies in the disparate relative sizes of the central and regional governments in the United States as against Europe. In the United States, federal government spending represents some 25 percent of GDP and is 20 times as great as California's state expenditure. In Europe, by contrast, the community's budget represents only just over one percent of community **GDP** and is only one-tenth of the expenditure of West Germany.

What do these differences mean for the process of economic and monetary union in Europe? In the first place, they suggest to me a need for gradualism and pragmatism. Consider the role of goods and factor mobility. This is essential to the success of a common monetary area, since it provides the means by which disturbances in demand or prices in individual regions are spread throughout the union. In other words, it is a safety valve against the intensification of localized inflationary or deflationary pressures. Europe, as I said, is gradually becoming more integrated and the degree of goods and factor mobility is increasing, but there are serious economic and political risks in allowing the process of monetary union to run ahead of integration in the underlying markets for goods, labor, and capital.

For the same reasons, the business cycles in the European economies cannot be expected always to be precisely in phase, so that the monetary policy needed in one part of Europe will, for the foreseeable future, not necessarily be the same as that needed

elsewhere. (This is, of course, true in the United States also, and indeed was one reason for the choice of a federal structure for the central bank—but the original goal of regional autonomy in monetary policy has proved unattainable in a union with a single currency.)

Coping with regional differences

If Europe is not yet an optimum currency area, we need to consider how community monetary arrangements might take account of prospective regional differences in economic conditions. I think three broad options can be identified. The first would be to allow interest rates to continue to diverge to some extent as cyclical conditions vary. Some such flexibility is, in fact, provided by the existence of fluctuation bands around central exchange rates within the present Exchange Rate Mechanism and the possibility of realignments.

A second way of coping with different national or regional policy requirements would be through an intensification of policy coordination. Our collective objective must be to pursue policies which are consistent with communitywide price stability, taking full account of the interdependence of individual national economies.

A third option would be to make use of other policy instruments. I am afraid the Delors Report has been much misunderstood on this matter. Two of the mechanisms it suggested—fiscal policy coordination and regional transfers—have been widely criticized. Another mechanism, competition policy, has been given much less attention than I believe it deserves. Allow me to elaborate briefly on these points.

In the Delors Committee, we saw fiscal policy as having importance for monetary management for several reasons. First, the fiscal stance of individual member states has implications for capital market pressures, and therefore, interest rates, throughout the community. Second, an inappropriate **fiscal/monetary** policy mix can make it harder for countries to reconcile the objectives of internal and external stability. Third, excessive fiscal deficits can lead to unsustainable borrowing and a loss of creditworthiness by the borrowing country. I believe these are important and legitimate concerns, particularly given that the individual member states, and not the central community bodies, carry the main fiscal responsibility. However, neither I—nor, I think, my colleagues on the committee—saw a need for

specific and detailed budgetary rules. We were simply expressing a rather straightforward proposition: namely, that the mix of monetary and fiscal policy is **as** important in a monetary union **as** in an individual country and that limits, which might be quite wide, should be put on the size of individual deficits.

Let me turn now to regional policy. I am not a believer in government intervention as a means of overcoming regional disparities in incomes or employment for the simple reason that I do not think it can deliver durable results. But I am enough of a realist to recognize that greater economic integration will not necessarily benefit all regions equally. Within a country like the United States, the effects of regional differences in economic welfare can be partly offset by the kind of transfers that arise from the national income tax and welfare system, and ultimately, through inward or outward migration. Such offsets are, as I noted earlier, less readily available in Europe and it seems to me legitimate to ask what mechanisms should exist in their place. Indeed, I believe it is incumbent on those who would like to accelerate the pace of monetary union to explain how regional disparities could be solved satisfactorily in economic terms and acceptably in political terms.

The third element stressed in the Delors Report—and the one which has received too little attention—was competition policy. Europe still has its fair share of rigidities; therefore, I believe reforms that strengthen the role and efficiency of markets can be seen as not only desirable in their own right, but part and parcel of a move toward greater economic integration. If rigidities in the functioning of markets can be reduced or removed, natural adjustment mechanisms will be more effective and exchange rate adjustment will become less important.

My remarks this afternoon have ranged quite widely over some of the issues that will be presented by the 1990s. As central banks, we have long recognized that our freedom to conduct an independent monetary policy is constrained by the economic and financial links that bind our countries together. These constraints have typically been greater for small countries than for large ones, although in Europe we now realize that even countries that are large in a European context may have limited freedom to formulate policies independently.

Growing economic and financial integration in Europe in part

reflects similar trends taking place on a global scale. The monetary arrangements devised for Europe should, therefore, be compatible with increasing cooperation between the major regions of the industrial and, indeed, the developing world. It will be of key importance for the world economy in the 1990s that the three major economic blocs coordinate their efforts toward price stability, an effectively functioning international payments system, and an open trading regime. I believe that the 1992 process will make Europe a stronger partner in all these endeavors.